

**Management Advisory Report: The Small  
Business/Self-Employed Division Needs to  
Further Consider the Impact of Potential  
Examination Reengineering  
Recommendations**

**December 2001**

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DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

December 19, 2001

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner  
Deputy Inspector General for Audit

SUBJECT: Final Management Advisory Report: The Small Business/  
Self-Employed Division Needs to Further Consider the Impact of  
Potential Examination Reengineering Recommendations  
(#200230007)

This report represents the results of our review of the preliminary recommendations of the Small Business/Self-Employed (SB/SE) Division's Examination Reengineering Project Team. The overall objective of this review was to provide ongoing input regarding the SB/SE Division's examination reengineering effort. Specifically, we assessed the impact of the reengineering team's recommendations on the internal control environment and on taxpayer relations/taxpayer rights. We also brought to management's attention any other concerns we identified. This management advisory report is provided for informational purposes to assist Internal Revenue Service (IRS) management in its efforts to modernize the IRS.

In summary, the 23 preliminary recommendations proposed by the SB/SE Division's Examination Reengineering Project Team should not adversely affect the existing control environment. In fact, many of the proposed recommendations may improve the control environment. However, we identified some recommendations where a more careful consideration of the impact on taxpayer relations/taxpayer rights is needed. In addition, the procurement of automated examination workpaper software needs management's oversight. Finally, management will have difficulty measuring the effectiveness of the recommendations on examination productivity.

Since we are making no recommendations in this management advisory report, a response is not required. Copies of this report are also being sent to the IRS managers affected by the report. Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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### **Background**

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The Small Business/Self-Employed (SB/SE) Division serves approximately 40 million taxpayers that pay \$915 billion in taxes annually. These taxpayers consist of 7 million small businesses, including corporations and partnerships with assets of \$10 million or less, and 33 million self-employed and supplemental income earners.

The SB/SE Division's Examination function examines tax returns to ascertain whether taxpayers have correctly determined their tax liability. SB/SE Division management has expressed concern about the significant decline in examination productivity in recent years. For example, the number of tax returns examined went from 1 out of every 79 in 1988 to 1 out of every 232 in 2000. This drop has been particularly drastic since the beginning of 1998. In addition, revenue agents' time per return has increased. For example, hours per return for individual and corporation returns increased by 24 percent and 47 percent, respectively, from 1998 to 2000.

Because of this concern, in May 2001, the SB/SE Division initiated an in-depth effort to reengineer its examination processes, products, and services. Expected project deliverables include streamlining the examination process, increasing the effectiveness and timeliness in examining tax returns, and decreasing and redirecting expenditures within the SB/SE Division. Assisting in the reengineering of the examination processes is a consulting contractor and a contractor with auditing and accounting expertise.

The SB/SE Division's Examination Reengineering Project Team members identified 23 potential recommendations that are being further studied for development. As part of the reengineering effort, the Commissioner, SB/SE Division, requested the Treasury Inspector General for Tax Administration to provide ongoing input during the project. We are issuing this report to advise the Commissioner, SB/SE Division, of our observations to date.

The overall objective of this review was to provide ongoing input regarding the SB/SE Division's examination reengineering effort. Specifically, we assessed the impact of the reengineering team's recommendations on the internal control environment and on taxpayer

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relations/taxpayer rights. We also brought to management's attention any other concerns we identified.

This review was conducted at the SB/SE Division Headquarters in Washington, DC, from May through November 2001, in accordance with the President's Council on Integrity and Efficiency's *Quality Standards for Inspections*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to this report are listed in Appendix II.

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### **Preliminary Recommendations Should Not Negatively Affect Internal Controls**

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Overall, the 23 preliminary recommendations proposed by the SB/SE Division's Examination Reengineering Project Team should not negatively affect the existing control environment. In fact, a number of the proposed recommendations could improve the control environment. Recommendations which should have a positive impact on the control environment include increased management review requirements and a standardization of examination workpapers.

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### **Management Attention Is Needed to Ensure Recommendations Do Not Adversely Affect Taxpayer Relations**

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The Examination Reengineering Project Team is preliminarily recommending some initiatives which could have an adverse impact on taxpayer relations and taxpayer rights. For example, the reengineering team is considering changes to the initial examination contact letter process, including adding information on proposed tax adjustments if the taxpayer does not respond to the letter. While these proposed changes may increase response rates, the changes could also have a negative effect on taxpayer relations and are contrary to the numerous Internal Revenue Service (IRS) efforts to improve customer service. Management needs to fully weigh the costs, in terms of taxpayer relations, of any changes it is considering in the way it communicates with taxpayers.

In addition, recommendations have been made regarding the examination case processing actions the IRS takes in order to meet the requirements of the IRS Restructuring and Reform Act of 1998 (RRA 98).<sup>1</sup> Because any responsibilities placed upon the IRS by the RRA 98 cannot be eliminated without legislative change, significant care needs

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<sup>1</sup> Pub. L. No. 105-206, 112 Stat. 685.

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to be exercised when considering any procedural changes in this area. For example, the reengineering team is recommending eliminating managerial review of examination penalty cases. However, the review of penalties is required by Section 3306 of the RRA 98, so the proposed change would require legislative approval.

The reengineering team has not yet requested the involvement of the SB/SE Division Chief Counsel in evaluating any recommendations involving the RRA 98. This could negatively affect planned project rollout. Consequently, the reengineering team should consider engaging Chief Counsel in this process as soon as possible.

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### **Management Needs to Provide Careful Oversight of Any Workpaper Software Procurement**

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As part of the reengineering effort, the SB/SE Division is considering the procurement of software to allow for standardized examination workpapers. Because of the potential for duplication of efforts already ongoing or planned elsewhere in the IRS, careful planning of this effort is needed. For example, the Large and Mid-Size Business (LMSB) Division has already acquired Corporate Tax Analyzer Software, which allows examiners to conduct complex tax calculations on notebook computers. In addition, the Reporting Compliance Project,<sup>2</sup> scheduled to begin in December 2001, is designed to address the technical and software needs of all four IRS operating divisions. The Reporting Compliance Project is expected to provide a total tax package, including a report-generating feature.

Further, a contract involving a workpaper product for all 15,000 compliance personnel in the SB/SE Division Examination function would be of potentially significant value. Therefore, management needs to ensure that the procurement policies and procedures are followed, that there is appropriate coordination with the LMSB Division and the

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<sup>2</sup> The Reporting Compliance Project will focus on the use of improved and redesigned tools and technology to make the IRS examination process more efficient. Ownership for the project is shared jointly among the IRS' four operating divisions.

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### **Management Will Have Difficulty Measuring the Effectiveness of Recommendations That Are Implemented**

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Reporting Compliance Project, and that the procurement represents the best value to the government.

The 23 preliminary recommendations proposed by the reengineering team primarily represent either a strengthening of existing procedures or an implementation of best practices. For example, 6 (26 percent) of the 23 recommendations involve either strengthening management oversight or standardizing work products.

The remaining recommendations generally focus on improving existing procedures regarding the selection and ordering of returns, scheduling meetings with taxpayers, case building,<sup>3</sup> and workload planning. These recommendations are preliminary and need further development. Consequently, we could not determine whether they will have measurable impact on improving examination effectiveness and timeliness.

Furthermore, SB/SE Division management may have difficulty in measuring the impact of any changes made as the result of the reengineering project. For example, the decline in examination productivity in recent years can be attributed partially to the re-deployment of Examination function resources to provide direct assistance to taxpayers during the filing season. This re-deployment not only lessened resources available to work cases but also interrupted the continuity of case processing, resulting in increased cycle time per case.

In FY 2002, the SB/SE Division plans to significantly reduce its commitment to direct assistance to taxpayers. As the reengineering team's recommendations are implemented, management will have difficulty determining whether any productivity gains are attributable uniquely and directly to these recommendations, to the increase in resources spent on examinations, or to other factors. Consequently, as part of the implementation of the

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<sup>3</sup> Case building is a process whereby useful data, such as historical filing information, are developed and added to the case file before a return is assigned for examination.



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reengineering team's recommendations, SB/SE Division management should specifically consider how the success of the recommendations will be measured.

## **Appendix I**

### **Detailed Objective, Scope, and Methodology**

The overall objective of this review was to provide ongoing input to Internal Revenue Service (IRS) management regarding the Small Business/Self-Employed Division's examination reengineering efforts. In order to accomplish our objective, we:

- I. Assessed the impact of the reengineering team's recommendations on the internal control environment and on taxpayer relations/taxpayer rights.
  - A. Attended project team meetings and interviewed selected IRS and contractor project team leaders.
  - B. Analyzed potential recommendations and supporting workpapers.
  - C. Researched IRS procurement policies and reviewed selected procedures related to the implementation of the IRS Restructuring and Reform Act of 1998.<sup>1</sup>
- II. Brought to IRS' attention other concerns, which were identified during the course of our review.

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<sup>1</sup> Pub. L. No. 105-206, 112 Stat. 685.

**Appendix II**

**Major Contributors to This Report**

Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs)

Parker F. Pearson, Director

Anthony Choma, Audit Manager

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Joseph P. Snyder, Senior Auditor

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**Appendix III**

**Report Distribution List**

Commissioner N:C  
Deputy Commissioner N:DC  
Deputy Commissioner, Small Business/Self-Employed Division S  
Director, Examination Reengineering Project Team, Small Business/Self-Employed Division S:C  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O  
Office of Management and Controls N:CFO:F:M  
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